

## **Employment Tax Adjustment Program**

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**This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**

### **Redaction Legend:**

2d = Law Enforcement Technique(s)

2e = Law Enforcement Procedure(s)

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### Executive Summary

The Internal Revenue Service (IRS) implemented the Employment Tax Adjustment Program (ETAP) in 1986 to deal with the increasing number of employers who were shifting the classification of their workers to self-employed or independent contractors. The ETAP Program is driven by audit leads from unemployment tax audits performed by states with which the IRS has agreements for the exchange of tax information. The IRS uses the state audit results to propose adjustments to Federal employment tax returns.

Our original objective was to determine whether IRS management has taken effective corrective actions to the prior audit findings and recommendations that pertained to the ETAP. Based on our early discussions with IRS executives, however, we modified the focus of the audit to consider other more significant issues that were impacting the operation of the ETAP Program at the Detroit Computing Center (DCC).

### Results

Our review confirmed that there are significant legal and operational issues that exist which seriously undermine the continued existence of the ETAP Program at the DDC. These issues include:

- The current ETAP Program requires significant modifications to comply with recently enacted legislation and, even then, will be limited to processing only agreed adjustment cases. No response cases and unagreed or partially agreed cases will have to be referred to the field for processing under examination deficiency procedures.
- The current ETAP Program structure and process, originally designed in 1986, is not consistent with current Examination Program guidelines which call for the pursuit of worker classification issues 2d, 2e-----
- IRS contacts with employers made through the ETAP Program that result in no adjustment may be potentially creating prior audit safe harbors under Section 530 of the Revenue Act of 1978.
- A serious shortage of state audit leads has steadily eroded productivity over the past three years and has created an inequitable taxpayer compliance program that is primarily focused on employers in one state.
- The existing systems of internal control do not provide reasonable assurances that the ETAP Program operates in an effective and efficient manner. Controls are lacking for screening leads, making quality adjustments, processing remittances,

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generating accurate management information reports, and correcting prior audit findings.

### **Summary Recommendations**

The centralized ETAP Program should be discontinued at the DCC. In our opinion, this action would be the most effective and efficient means to eliminate all the legal and operational concerns listed above. Terminating the program would enable the IRS to minimize taxpayer burden and divert resources into more productive compliance programs or tax education programs. Having the leads evaluated and worked, if appropriate, as part of the employment tax examination programs in field offices would place the IRS in a better position to ensure that taxpayer rights are protected, Section 530 determinations are made, and the various technical differences that exist between state and Federal employment tax laws are effectively applied.

### **Management's Response**

Management concurred with the recommendation and has taken action to terminate the ETAP Program at the DCC in an orderly fashion. All production was ceased and the ETAP Program was to be totally dismantled by October 1, 1998.

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### Objective and Scope

This audit was initiated as a follow-up to an Internal Audit report entitled "Review of the Implementation of Selected Enforcement Programs at the Detroit Computing Center (DCC)" that was issued on June 9, 1995. Originally, our primary objective was to determine whether Internal Revenue Service (IRS) management has taken effective corrective actions to the prior audit findings and recommendations that pertained to the Employment Tax Adjustment Program (ETAP).

*Recent tax law changes and a dwindling supply of audit leads have adversely affected the operation and productivity of the ETAP Program at DCC.*

Based on our early discussions with IRS executives, however, we modified the focus of the audit to also consider other more significant issues that were impacting the operation of the ETAP Program at DCC. These issues included recent tax legislation which may preclude the IRS from utilizing mass processing techniques to "adjust" employment tax accounts and a sharply declining inventory of work which is materially affecting the productivity of the ETAP Program.

We conducted the review during June and July 1998 at the DCC and the National Office. We followed generally accepted government auditing standards.

A detailed Scope of Review is presented as Attachment I.

### Background

*The basis for ETAP was a Counsel advisory opinion that allowed for using third party information in proposing adjustments if the information was secured through formal and informal Federal/State agreements.*

The IRS uses various enforcement programs to collect the proper amount of tax at the least cost. The IRS permanently implemented the ETAP program in 1986 to deal with the increasing number of employers who were shifting the classification of their workers to self-employed or independent contractors.

The ETAP program is driven by audit leads from unemployment tax audits performed by states with

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which the IRS has agreements for the exchange of tax information. Tax Examiners use the state audit results to propose adjustments to Federal employment tax returns. The employers are given an opportunity to agree to the proposed adjustment and pay the assessment, or provide information verifying the independent contractor status of the workers or other wage issues. If there is no response from the taxpayer, the tax is assessed and the taxpayer is billed for the balance due.

*The IRS moved the ETAP Program from the service centers to the DCC as a replacement for payroll processing work.*

The ETAP Program evolved from the use of state unemployment tax audits as leads for employment tax examinations performed by Revenue Officer Examiners (ROEs) assigned to the Collection function in IRS district offices. ETAP was originally designed to make correspondence adjustments on smaller dollar cases than would be assigned to the ROE program and to utilize relatively inexpensive service center resources instead of more expensive field personnel.

The IRS centralized the ETAP Program at the DCC in 1994 to provide replacement work for the DCC's loss of payroll processing responsibilities. Historically, the ETAP program has assessed taxes on cases that are agreed, cases for which no response was received from the taxpayer, or cases for which an inadequate response was received. Cases that are unagreed have been either assessed, closed "no change", or, in limited instances, referred to the Examination function in the district offices. These included cases where the taxpayer claims safe haven under Section 530.

*Functional responsibility for the ETAP Program was transferred from Collection to Examination in 1996.*

The Assistant Commissioner (Examination), through the Office of Employment Tax Administration and Compliance (OETAC), is responsible for providing the national program direction, funding, and oversight for the ETAP Program. The Director, DCC, through the Chief, Currency Reporting and Compliance Division, is responsible for the effective and efficient management of the ETAP Program at DCC.

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### Results

Our audit showed that IRS management should take action to immediately terminate the operation of a centralized ETAP Program. This conclusion is based on the following factors:

*The continued operation of a centralized ETAP Program is no longer feasible.*

- New tax legislation, which provides taxpayers with judicial review rights on employment tax determinations, diminishes the IRS' ability to operate a viable ETAP Program.
- The ETAP Program is inconsistent with current Examination program guidelines that call for the pursuit of worker classification issues 2d, 2e-----  
2d, 2e-----
- IRS contacts with employers made through the ETAP Program may be creating prior audit safe harbors.
- A shortage of state audit leads is significantly eroding the IRS' ability to administer a productive and equitable ETAP program.
- The systems of internal control do not provide reasonable assurance that the ETAP Program operates in an effective and efficient manner.

Our detailed audit results follow:

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### **The IRS Should Take Action to Immediately Terminate the Centralized ETAP Program.**

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Terminating the centralized ETAP Program would enable the IRS to minimize taxpayer burden and divert resources into more productive compliance programs or tax education programs. Having the leads evaluated and worked, if appropriate, as part of the employment tax examination programs in field offices would place the IRS in a better position to ensure that taxpayer rights are protected, Section 530 determinations are made, and the

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various technical differences that exist between state and Federal employment tax laws are effectively applied.

### **New Tax Legislation Diminishes the IRS' Ability to Operate a Viable ETAP Program.**

At the time we began our review in June 1998, the ETAP Program was essentially in a suspense status pending the resolution of a number of legal issues that were attributable to the recent enactment of new tax legislation. The Taxpayer Relief Act of 1997 added a new Section 7436 to the Internal Revenue Code (IRC) that provides new judicial review rights concerning certain employment tax determinations. This tax law change, which applies to employee/independent contractor classification issues, significantly jeopardizes the ability of the IRS to continue the ETAP program under its current method of operation.

*Employers now have the right to take employment status disputes to Tax Court.*

Effective August 5, 1997, Section 7436 gives the Tax Court jurisdiction to review IRS determinations in employment tax examinations in which the IRS has determined that (1) at least one worker who performs services for the taxpayer should be classified as an employee, or (2) the taxpayer is not entitled to relief from employment taxes under Section 530 of the Revenue Act of 1978.

Section 7436 requires that any employment tax that depends on such determinations cannot be assessed unless the taxpayer has been given an opportunity to file a petition for Tax Court review of the Service's determinations on those two issues. Additionally, Section 7436(a) states that the required determination by the IRS must be made "as part of an examination."

*IRS procedures for complying with IRC 7436 did not address the ETAP program.*

On September 8, 1997, the Acting Chief Compliance Officer issued a memorandum to the Regional Chief Compliance Officers which provided procedures which the Examination and Appeals functions should follow on cases containing any issue of worker classification and/ or Section 530 treatment. The procedures stated that taxpayers should be informed of the opportunity to seek Tax Court review at the same time as they are



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informed of their appeal rights. The procedures provided that the taxpayer should be advised that Tax Court review is not available for agreed cases. The procedures also stated that if, during the course of the employment tax examination, the taxpayer and Examination are unable to agree on worker classification and/or Section 530 issues, the taxpayer should be strongly encouraged to request early referral of these unagreed issues to Appeals.

The procedures issued by the Acting Chief Compliance Officer did not specifically mention the ETAP Program. However, subsequent informal contacts between OETAC and the office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations) indicated that the new IRC 7436 requirements were applicable to ETAP even though the adjustments made by the ETAP Program do not constitute employment tax examinations.

As a result, all unprocessed ETAP cases involving either a "no response" or an "unagreed" response from the taxpayer have been held in suspense at DCC since August 1997 pending decisions from OETAC and/or Counsel regarding the specific modifications to the ETAP adjustment notices and other work processes that would be necessary to meet the requirements of Section 7436.

*All ETAP adjustments made since August 1997 may have been illegal.*

ETAP cases involving an "agreed" response have continued to be processed and assessed. However, all assessments made since August 1997 may be illegal since the proposed adjustment notices used by the DCC did not obtain the taxpayer's consent to waive their right to contest the issue in Tax Court.

On June 22, 1998, the Assistant Chief Counsel (Employee Benefits and Exempt Organizations) issued a memorandum to the Director, OETAC, in response to the request for assistance regarding procedures for complying with the IRC Section 7436. The memorandum stated that ETAP assessments could be made only if taxpayers agree to the proposed adjustments and provide a signed agreement form which

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contains the necessary language waiving their rights to contest the issues in tax court.

Because ETAP cases do not involve examinations and do not result in any determination with respect to whether the taxpayer is entitled to Section 530 relief, the memorandum stated that it will be necessary to forward certain unagreed and "no response" cases to the district offices for examination prior to issuing a Notice of Determination Concerning Worker Classification Under Section 7436.

*Recent Counsel opinion limits the ETAP Program to processing agreed cases only.*

In our judgment, the above opinion from Counsel significantly minimizes the potential that the IRS could continue to operate an effective and efficient ETAP Program. Continuing to process "agreed" cases while forwarding "unagreed" and "no response" cases to the field for examinations would negate the cost benefits derived from utilizing mass processing techniques.

In addition, continuing the ETAP Program would likely result in inequitable treatment of taxpayers since there are concerns as to whether the ETAP referrals would meet the IRS' current criteria for initiating employment tax examinations. Thus, taxpayers who agree would be assessed while those who disagreed or failed to respond would potentially be ignored. This issue is discussed further in the following section of this report.

### **The ETAP Program is Inconsistent with Current Examination Program Guidelines Which Call for the Pursuit of Worker Classification Issues 2d, 2e-----**

*Examination has had functional responsibility of the ETAP Program since 1996.*

Each fiscal year, Examination issues a Program Letter that identifies and prioritizes the areas of emphasis where Examination will focus its attention. The Program Letter also defines the efforts Examination will undertake in the current year to support the Strategic Plan and Budget.

For FY 1998, the guidelines for the Employment Tax Program state that Examination will 2d, 2e-----  
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*The ETAP Program proposes assessments that exceed a minimum dollar tolerance.*

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### **IRS Contacts with Employers Made Through the ETAP Program May Be Creating Prior Audit Safe Harbors.**

*The prior audit safe harbor was subsequently limited by the Small Business and Job Protection Act of 1996 to include only examinations of the status of the class of workers at issue or of a substantially similar class of workers.*

Congress enacted Section 530 of the Revenue Act of 1978 to provide relief for employers involved in employment tax controversies with the IRS. In general, Section 530 terminated employers' liability for employment taxes in those cases where they have a "reasonable basis" for not treating a worker as an employee.

One of the "safe havens" which qualifies as "reasonable basis" under Section 530 is a past IRS examination of the employer that entailed no assessment attributable to the employer's tax treatment of the individual whose status was at question. It was the intent of Congress that "reasonable basis" should be construed liberally in favor of the taxpayer.

An April 1, 1998, memorandum<sup>1</sup> issued by the Assistant Chief Counsel (Employee Benefits and Exempt Organizations) concerning whether certain IRS correspondence with taxpayers would be considered an examination or compliance check seemingly has applicability to the ETAP program. For example, the memorandum stated that, because of the extremely liberal interpretation that the courts have accorded the provisions of Section 530, it would be wise to treat any activity that a taxpayer might perceive as an audit as if it were an examination for the purposes of Section 530.

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<sup>1</sup> Request for a Technical Opinion – Business Information Database (BID) WTA-N-103412-98

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*ETAP cases that result in no adjustment could prevent the IRS from future challenges to the employer's classification of workers.*

Thus, Counsel advised that asking a taxpayer why workers were treated as employees or independent contractors could create a prior audit safe harbor. Counsel added that, if an examiner wishes to ask questions about worker status, the examiner should either open an examination or anticipate that the taxpayer will have a successful defense in subsequent litigation.

Based on the opinions cited in the above memorandum, the potential exists that the ETAP Program's contacts with employers (i.e., proposed adjustment letters as well as other subsequent correspondence or telephone contacts with the employers to explain and/or resolve disagreements on worker status issues) that do not result in the reclassification of workers could be found by the courts to constitute a prior audit under Section 530. For these employers, the IRS would be prohibited from any future challenges or corrections concerning the treatment of similar workers as independent contractors.

### **A Shortage of State Audit Leads is Significantly Eroding the IRS' Ability to Administer a Productive and Equitable ETAP Program.**

*The number of state audit leads declined by 50% in FY 1997.*

The program results produced by the centralized ETAP Program have significantly declined in recent years. Management at DCC attributes the decline in productivity to a significant decrease in the volume of audit leads received from the state agencies. For example, the volume of leads received by DCC dropped from 9,400 in Fiscal Year (FY) 1996 to 4,700 in FY 1997.

Part of the decline in audit leads is uncontrollable since some states have been performing fewer unemployment tax audits. For example, the State of Oklahoma has indicated that they have not performed any employment tax audits for the past three years.

However, management at DCC attributed the shortage of leads to the fact that Examination has not clearly delineated responsibility for working state audit leads between the DCC and the district offices. In addition,

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DCC management believes that the IRS has not effectively marketed the ETAP program with the states to ensure a continuous and optimum flow of audit leads to the DCC.

### **The declining inventories are having a detrimental impact on ETAP program accomplishments.**

The following table shows that the ETAP program has experienced a significant reduction in cases closed, total dollars assessed, dollars assessed per staff hour, and dollars collected between FY 1996 and FY 1997:

### ***Comparison of ETAP Program Accomplishments<sup>2</sup>***

*ETAP assessments declined by 60% between FY 1996 and FY 1997.*

<u>Measurement</u>	<u>FY 1996</u>	<u>FY 1997</u>
Cases Closed	666	466
Total Dollars Assessed	\$3,514,558	\$1,420,228
Dollars Assessed Per Staff Hour	\$ 235	\$ 119
Total Dollars Collected	\$ 568,351	\$ 470,404

The decline in ETAP productivity has escalated in FY 1998 due to the impact of the Taxpayer Relief Act of 1997 and the continued shortage of fresh audit leads. During the first quarter, for example, the DCC closed only 35 cases, produced total assessments of \$62,109, and yielded an average of only \$25 in assessed taxes per staff hour.

*The ETAP program was far more productive when it was operated from the service centers.*

By comparison, FY 1993 was the last full year that the ETAP program was operated in the service centers. During that year, the ETAP program closed 1,831 cases, produced total assessments of \$7,237,123 and yielded \$410 per staff hour.

As shown in the following table, the average dollar assessments per staff hour that were achieved nationally by the various district office employment tax

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<sup>2</sup> Per "ETAP National Office Reports" produced from the ETAP Inventory Delivery System (IDS).

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examination programs in FY 1997 were significantly higher than ETAP.

### ***Comparative Productivity of Employment Tax Examination Programs at the District Office Level with ETAP – FY 1997***

*The \$119 per hour produced by ETAP in FY 1997 was significantly less than the employment tax examination programs.*

<u>Examination Program</u>	<u>Dollars Per Hour</u>
Revenue Officer Examiner	\$ 620
Revenue Agent – Employment	\$1,388
Tax Auditor – Other	\$ 813
<u>Adjustment Program</u>	
ETAP	\$ 119

*More staff hours are expended per ETAP case than are spent during examinations of taxpayers' records.*

Another indicator of program inefficiency was the average number of hours per case charged by DCC versus the average number of hours per return charged by the other examination programs. In FY 1997, for example, the DCC charged an average of 25 hours per case as compared to 9.4 hours, 7.7 hours, and 3.7 hours per return that were charged by the above three examination programs, respectively. When both "case time" **and** "clerical time" are considered, the DCC charged an average of 59 hours per case and produced only \$48 in average assessments per staff hour worked.

Collectively, these accomplishments indicate that the Service would potentially benefit from decentralizing the ETAP Program and integrating the state audit leads into the various sources of inventory for the district office employment tax examination programs.

### **ETAP Program resources are not being effectively utilized at the DCC.**

Largely because of the declining inventory of leads, the ETAP program only realized 20 of the 32 staff years that were allocated to the DCC in FY 1997. Of the 20 staff years realized, 14 were charged to Direct Time and 6 to Overhead. Only 5.7 of the 14 staff years charged to Direct Time were devoted to "case time".

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*Resources dedicated to the ETAP Program have been underutilized.*

When they have lacked sufficient cases to keep them busy, Tax Examiners have charged their time to "clerical" duties instead of "examining" duties. During FY 1997, Work Planning and Control (WP&C) System reports showed that 15,879 hours were charged to "clerical" while only 11,949 hours were charged to "examining". Ideally, the amount of "examining" time should exceed the amount of "clerical" time by about 250% since the ETAP program at DCC is authorized 13 Tax Examiner positions as compared to only 5 Clerical positions. The current on-board staffing is 10 Tax Examiners and 4 Clerical.

Management at DCC has held off on filling vacancies in the ETAP Section due to the lack of work. Management at DCC was also considering the need to detail some of the current employees to other programs if the inventory problems and legal issues impacting the ETAP Program are not promptly resolved.

### **Declining inventories also raise questions about the fairness and equitableness of the ETAP program.**

California is the only state that the IRS pays for audit leads. A contract with the State of California Employment Development Department was initiated by the DCC in February 1994 and has been renewed on an annual basis. The annual cost of the contract is between \$5,000 and \$6,000.

*Nearly 80% of the leads received in FY 1997 came from one state.*

During the last two years, the leads received from California have essentially sustained the ETAP program. Of the 4,700 leads received in FY 1997, for example, approximately 3,600 (77%) were received from California.

Thus, the centralized ETAP program has evolved into a program that is essentially targeting employers in one state instead of the national program that it was intended to be.

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### **IRS management has not clearly delineated responsibility for working state audit leads between the DCC and the district offices.**

Some of the existing Fed/State agreements were established prior to the 1986 development of the ETAP Program and all but one of the existing agreements was established prior to the 1994 centralization of the ETAP Program at the DCC. Therefore, many of the states are still forwarding audit leads to the IRS district offices.

The IRS has not issued any national directives since the initial centralization of the ETAP Program in 1994 to ensure that the field examination functions forward all state audit leads to the DCC for evaluation and processing. As a result, the supply of leads to the centralized ETAP program is being interrupted and/or filtered by some district offices. This situation contributes to the workload shortfall at DCC and undermines the operation of a viable and productive centralized ETAP program.

For example, a survey completed by Fed/State Coordinators at the request of IRS management in early 1998 showed that:

*Supply of audit leads to the DCC is being interrupted and/or filtered by IRS district offices.*

- Some district offices are sending all leads received from the states to the DCC.
- Some district offices may not have been aware that the program was centralized at the DCC and, as a result, have been working the leads locally.
- Some district offices have been screening the leads, selecting the ones with the most potential to be worked locally, and forwarding the remainder to the DCC. One district was forwarding the leads they didn't want to the Kansas City Service Center instead of the DCC.
- The Missouri Division of Employment Security initiated a process whereby all leads are forwarded, beginning in October 1997, to the Kansas-Missouri District for consideration. Prior to that time, all leads were sent directly to DCC.



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- Some districts indicated that they would continue working the leads at the district level.

### **The IRS has not effectively marketed the ETAP program with the states.**

Currently, 33 states have signed agreements to provide unemployment tax audit information to the IRS. However, the DCC has not received any leads from 12 of those states during the last two years. In addition, ten states that had previously supplied leads sent none during Fiscal Year 1997. Only one state increased the supply of leads.

This diminishing supply of leads, along with the results of the recent survey completed by the Fed/State coordinators, shows that OETAC and the Office of Fed/State Relations would need to develop a more aggressive and coordinated marketing strategy if IRS management continues the operation of the ETAP Program.

For example, the survey results showed that:

*There may be an overall need to secure new agreements if the IRS continues the centralized ETAP program at DCC.*

- The IRS does not have an agreement with the State of Illinois to secure employment tax audit leads. However, the Illinois Department of Employment Security indicated that they would be willing to supply the leads to the DCC if the IRS would provide assurances that they would be worked.
- Some states have been providing the IRS with fewer leads or no leads because of perceptions that the leads were no longer wanted by DCC due to resource cuts and diversion of resources to higher priorities.
- The decline in leads from some states was attributable to the 1995 reorganization of the IRS that merged many of the IRS district offices.
- The decline in referral activity from some states was attributable to the shift of the ETAP program to the DCC. For example, the State of New York has specifically stipulated that their audit results be used only as leads for district employment tax

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examinations rather than as the basis for outright adjustments since that was the understanding when their agreement was negotiated in 1987.

Although the dwindling supply of audit leads has been a management concern for the past two years, the issue has not been elevated to the point where the ETAP Program has been included in the annual Fed/State Program Letter.

Another example of the need for coordination is that the California Fed/State coordinators were working on a statewide Memorandum of Understanding (MOU) that was already in effect in the IRS' Southern California and Central California District offices. This MOU streamlines the exchange of audit leads between the state and the IRS and has the potential to eliminate the need for the ETAP tape that the DCC is paying for. In March 1998, DCC management requested that the Office of Fed/State Relations suspend the MOU since the elimination of the ETAP tape would essentially put the ETAP Program out of business.

### **Systems of Internal Control Do Not Provide Reasonable Assurance that the ETAP Program Operates in an Effective and Efficient Manner.**

*Standards for internal controls in the Federal government are prescribed by the Comptroller General.*

Internal control systems are needed to provide reasonable assurance that program goals and objectives are met; resources are adequately safeguarded and efficiently utilized; reliable data are obtained, maintained and fairly disclosed in reports; and laws and regulations are complied with.

Our discussions with management and limited reviews of cases and other documentation indicate that the system of internal controls at DCC were not adequate to provide reasonable assurance that the centralized ETAP Program operated in an effective and efficient manner.

### **Limited Quality Controls Exist Over the Screening of ETAP Leads.**

Employees in the ETAP Section perform research to screen out the state audit leads that do not meet criteria

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to become adjustment cases. Leads that are screened out include those involving wage amounts that are below tolerance, defunct businesses, taxpayers with open examinations, and expired assessment statutes.

Typically, less than 10% of the audit leads received from the states actually become "cases" that result in proposed employment tax adjustments. During FY 1996, for example, the DCC opened only 811 cases from the approximately 9,400 leads that were received. In FY 1997, only 451 cases were opened from the approximately 4,700 leads that were received.

*Surveyed leads receive little management review before they are destroyed.*

There are little formal quality controls in place to ensure the adequacy of the screening process. Management at DCC advised us that sample reviews of the surveyed leads are periodically performed. However, no documentation of these reviews is maintained.

Overall, we were unable to independently evaluate the adequacy of the lead screening process since the leads are promptly destroyed once it is determined that they will not be converted to cases. However, we did identify one significant issue among the 42 surveyed leads that were still on hand at the time of our review.

*The ETAP Program was not taking action on state audit leads if the adjustment would benefit the taxpayer.*

For 8 of the 42 surveyed leads, the state's audit had shown that the employer had overreported wages on the state unemployment tax return. We were advised that the Tax Examiners at DCC do not convert leads to cases unless the proposed adjustment to the Federal employment tax return would result in an assessment of additional taxes.

The Internal Revenue Manual (IRM) does not specifically include overreported wages as one of the criterion that precludes an adjustment being made. However, IRM guidelines for making wage comparisons between the state and Federal returns do not provide the ETAP Tax Examiners with clear directions as to how this issue should be handled. In addition, the Inventory Delivery System (IDS) screen does include "Overreported" as one of the allowable destroyed codes.

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Since the IRS mission is to collect the proper amount of tax, the treatment of this issue raises questions about the fairness of the ETAP Program. This issue could possibly bring unfavorable publicity to the IRS if it became known that only those cases with potential deficiencies are being processed.

### **Limited Quality Controls Exist for the Processing of ETAP Cases.**

When the state audit leads indicate that an adjustment to a taxpayer's federal employment tax account is necessary, Tax Examiners in the ETAP Section make the necessary wage recomputations and issue 30-day letters to the taxpayers proposing the additional tax assessments.

The Tax Examiners may receive correspondence, telephone calls, and/or payments from taxpayers in response to the 30-day letters. The Tax Examiners may close the case as a "no change" or reverse the adjustment if the taxpayer response is considered adequate to resolve the issue in question. If no taxpayer response is received, the Tax Examiners process the adjustment.

*Timeliness and quality problems were prevalent in a sample of closed cases.*

We reviewed a sample of 30 cases closed in FY 1997 to evaluate timeliness and quality of processing actions. We found that the average time between the receipt of the audit lead in the ETAP Section and the print date of the proposed adjustment case was 254 days, or approximately 8.5 months. As a result of these delays, 13 of the cases had a total of 45 tax periods for which no tax adjustment was proposed because of imminent statute dates.

Management at DCC advised us that, because of the small workload which currently exists, all ETAP leads are being worked without regard to priority codes.

Quality problems were identified in 11 of the 30 cases. Examples included:

- incorrect computations such as using the wrong wage information and omitting tax periods (6 cases);

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- adjustments made to some, but not all, tax periods for the same taxpayer identified on the audit lead (3 cases);
- adjustment made to underreported tax periods while ignoring overreported tax periods for the same taxpayer (1 case); and
- the basis for adjusting the proposed assessments was not documented (1 case).

Management at DCC advised us that reviews of closed cases are essentially limited to those cases which result in an adjustment. These reviews generally involve the information on the IDS screen and the results are not documented.

Management in the Currency Reporting and Compliance Division at DCC has attempted to establish a Quality Review Program for the various compliance programs for which they are responsible. Part of this effort included the February 1997 development of a comprehensive "Quality Review Standards and Review Guide" for the ETAP program. However, management advised us that the implementation of the standards has been delayed because of the declining workload in the ETAP Section.

### **Controls Over the Processing of ETAP Remittances Did Not Minimize the Risk of Misappropriation.**

When tax examiners in the ETAP Section at DCC receive state tax information indicating that an adjustment to a taxpayer's federal employment tax account is necessary, a 30-day letter is sent to the taxpayer. The 30-day letters advise taxpayers that, if they agree with the proposed adjustment, they should return payment to the DCC for the total amount shown on the enclosed Form 4666-A (Summary of Employment Tax Adjustment).

In FY 1997, the DCC received remittances totaling more than \$470,000 as a result of proposed ETAP assessments. The DCC collected more than \$568,000 during FY 1996.

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*Less than half of the ETAP remittances received at DCC have been recorded on IDS.*

Of the \$470,000 in remittances recorded in the check log for FY 1997, for example, only \$234,000 was recorded on IDS. In FY 1996, only \$222,000 of the \$568,000 collected was recorded on IDS.

*An adequate separation of duties does not exist within the ETAP remittance processing operation to provide sound internal control and minimize the risk of misappropriation.*

Our review showed that one clerical employee in the ETAP Section has a full range of remittance processing responsibilities as well as access to ETAP control records and taxpayer accounts maintained on computer systems. For example, this employee is responsible for opening the mail, endorsing any checks received, recording the checks in a manual check log, preparing the payment posting vouchers, preparing the bank deposit documentation, making the deposit at the Federal Reserve Bank, and forwarding the deposit package (i.e., payment posting vouchers and deposit ticket) to the service centers.

The same employee has complete access to the IDS containing the control records for the ETAP cases. In addition, this employee has been authorized command code capability to input adjustments to the taxpayers' accounts on the Integrated Data Retrieval System (IDRS).

We tested a sample of remittances from the check log and determined that all remittances were deposited and all posted to the taxpayers' accounts on IDRS. However, an unnecessary risk exists that the employee could misappropriate a remittance and avoid detection by changing the status of the case on IDS and/or by abating the tax adjustment on IDRS. This risk was compounded by the absence of an audit trail on IDS to track changes to ETAP control records.

### **Management Information Systems Are Inadequate for Monitoring Performance of the ETAP Program.**

*Accepted management practices require the development and use of a system to measure effectiveness.*

The IDS is designed to control ETAP cases that result from the leads provided by the states. Periodic management information reports are generated from the system. Management also has the capability to query the system for information.

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Both OETAC and DCC management officials indicated to us that IDS does not provide them the information they need to manage the ETAP Program or provide them with accurate information that can be relied upon.

Our discussions with DCC management and review of various management files at DCC identified a number of flaws in the ETAP management information system.

For example:

*Management has lacked the information to develop and refine the ETAP Program to its optimum levels of effectiveness and efficiency.*

- There is no specific accounting for the reasons that approximately 90% of the leads received do not result in proposed adjustment cases.
- There is no specific accounting for the reasons why only 23% of the proposed adjustment dollars in FY 1996, and 9% of the proposed adjustment dollars in FY 1997, were actually assessed.
- The IDS does not provide an accurate accounting of all remittances received. The manual check log of received remittances showed an additional \$236,000 over the amount recorded on IDS during an early part of FY 1997. In the fourth quarter of FY97, less than 50% of all checks received were recorded on IDS.
- In FY 1997, the IDS Lead Inventory Report showed a balance of over 7,000 leads while an actual count of leads showed only a few hundred.
- The monthly reports are designed to track “activity” rather than program results, such as dollars assessed.
- System developers working on IDS-Phase II informed ETAP managers in January 1998 that the existing IDS system had not been cleaned up in two years and that there were hundreds of cases with invalid status code/resolution code combinations.

At the time of our review, the development of IDS-Phase II was nearing completion. The new system may

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correct some of the above flaws if the operation of a centralized ETAP Program is continued.

### **All Corrective Actions to Prior Audit Findings Were Not Effectively Implemented.**

Management is required to promptly evaluate findings and recommendations reported by auditors; determine proper actions in response to audit findings and recommendations; and complete, within established time frames, all actions that correct or otherwise resolve the matters brought to management's attention.

Two prior internal audits, performed subsequent to the centralization of the ETAP program at the DCC, showed that management needed to establish an inventory system for tracking ETAP cases, develop performance standards for ensuring that ETAP cases are completely and timely processed, establish criteria for referring ETAP cases to other compliance functions, develop procedures for processing taxpayer inquiries, and revise the ETAP letter for educating reclassified workers.

### **Audit Findings That Were Effectively Corrected:**

- Criteria was identified for making referrals to other IRS functions.
- Management established an improved phone system when the DCC moved into their new building. Messages can be left on the telephones for the tax examiners as a method for controlling inquiries from taxpayers.

### **Audit Findings That Were Not Effectively Corrected:**

- Management developed procedures for prioritizing leads by dollar amount and for screening leads by statute date.

However, there is limited inventory control until the leads become cases. Tax examiners receive batches of 100 leads. Specific leads are not identified on IDS. Tax examiners should complete the "Disposition of Leads" to provide accountability, but

*An inventory system to effectively track ETAP leads has not been developed.*



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these are not reconciled. On June 24, 1998, we obtained leads that were screened out and designated for disposal. Eight of 42 leads were documented as received in ETAP between July 8 and December 31, 1996.

We were advised that Phase II of IDS, when implemented, would provide for the tracking of leads by Employer Identification Number.

*Performance standards for ETAP cases have not been implemented.*

- Management responded to prior internal audit reports that “Performance Standards have been established and are in use. In addition, a person has been assigned the responsibility of tracking and monitoring the established performance standards.” Management developed an ETAP Systems Map to identify measures such as hours per closed case and cases greater than 70 days old. Management also developed a “Quality Review Standards and Review Guide” in February 1997.

However, DCC management advised us that the implementation of the review guide has been delayed because of the declining ETAP workload. There is no indication that any ETAP cases have gone through any quality review function in the branch or the division, except for the Section Chief’s reviews.

- Form 9478CG, Filing Instructions for Reclassified Workers, is mailed to the taxpayer with the proposed adjustment. The employer is requested to provide a copy to all reclassified workers.

National Office management properly changed Form 9478-CG, Filing Instructions for Reclassified Workers, to provide accurate amounts for the maximum amount of wages subject to Social Security, Medicare and Self Employment Tax.

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*Revisions to the ETAP letter were not completely effective for educating reclassified workers.*

However, management did not accurately revise the letter to inform workers to file Form 4137 (Social Security and Medicare Tax on Unreported Tip Income), which the IRS uses as a means to report their own share of Federal Insurance Contributions Act (FICA) tax on their wages. The letter states that reclassified workers are to report their own share of FICA tax on any Unreported Tip Income. It should state that workers are to report their own share of FICA tax on their wages. This misstatement could create confusion as it is unlikely that these reclassified workers had any tip income. The ETAP letter is generated when cases are converted from leads to cases. There were 465 letters generated with the misleading statement during FY 1997.

### Recommendation

The centralized ETAP Program should be discontinued at the DCC. This action would minimize and/or eliminate (1) the impact of legal issues arising from recent tax legislation; (2) conflicts with current Examination program guidelines; (3) the risk of creating prior audit safe harbors; (4) the impact of a declining supply of audit leads from the states; and (5) the need to correct operational deficiencies with the current program at DCC.

### Management's Response

The Acting Assistant Commissioner (Examination) advised that he concurred with the recommendation and has taken action to terminate the ETAP Program in an orderly fashion. All production has been ceased and the ETAP Program was to be totally dismantled by October 1, 1998.

## Conclusion

The operation of a centralized ETAP Program is no longer feasible. In the years that have elapsed since the initial design and implementation of the ETAP Program, the IRS' focus on worker classification issues has

2d, 2e-----

2d, 2e----- In addition, the enactment of the Taxpayer Relief Act of 1997 and the continual decline in state audit leads raise serious doubts as to the IRS' ability to operate a centralized ETAP Program that is both cost effective and equitable to taxpayers.

In our judgment, terminating the program and having the state audit leads evaluated and worked, if appropriate, as part of the employment tax examination programs in field offices would place the IRS in a better position to protect taxpayer rights, minimize taxpayer burden, and divert resources into more productive compliance programs and/or taxpayer education programs.



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William E. Stewart  
Audit Manager

## Employment Tax Adjustment Program

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### Attachment I

#### Detailed Objectives and Scope

Our overall audit objective was to determine whether the ETAP Program is operating in an effective and efficient manner. Our specific objectives were to determine whether:

- Management implemented the corrective actions indicated in their response to the prior Internal Audit reports.
- The corrective actions implemented in response to the prior Internal Audit report, as well as other internal and management controls, were ensuring that the ETAP Program functions in an effective and efficient manner.
- Internal controls were in place and operating effectively to ensure that the ETAP Program is adequately protecting taxpayer rights while encouraging voluntary taxpayer compliance with employment tax laws.
- Service management has developed an effective strategy to reengineer the ETAP Program to ensure that it is compliant with new legal requirements contained in the Taxpayer Relief Act of 1997.
- Service management was taking sufficient actions to ensure the continuous flow of all available state audit leads to the centralized ETAP Program and to ensure that similarly situated taxpayers were treated consistently from an employment tax enforcement perspective.
- Internal controls were in place and operating effectively to ensure that ETAP remittances are properly secured, accounted for, and timely posted to taxpayer accounts.

Specific audit tests performed to achieve these objectives follow:

- I. To determine whether Service management implemented the corrective actions to the ETAP Program that were indicated in the response to the prior Internal Audit reports, we:
  - A. Ascertained whether an inventory system was established for effectively tracking the ETAP cases received.
  - B. Determined whether performance standards were developed to ensure that ETAP cases are completely and timely processed.
  - C. Established whether specific criteria were developed for referring ETAP cases to other compliance functions (i.e., Examination Division, Criminal Investigation Division, etc.) when appropriate.

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- D. Determined whether procedures were established for tracking phone messages and monitoring responses to ensure that taxpayer inquiries are promptly and accurately resolved.
  - E. Determined whether Form 9478-CG (Filing Instructions for Reclassified Workers) was revised to show accurate amounts for the maximum amount of wages subject to Social Security, Medicare and Self-Employment Tax, and to provide instructions for these workers to file Forms 4137 (Social Security and Medicare Tax on Tip Income) to report their own share of Federal Insurance Contributions Act (FICA) tax on their wages.
- II. To determine whether the corrective actions implemented in response to the prior Internal Audit report, as well as other internal and management controls, were ensuring that the ETAP Program operated in an effective and efficient manner, we:
- A. Interviewed ETAP managers and/or employees and conducted a walk-through to determine how cases were received, controlled, screened, assigned, prioritized, processed and monitored through the ETAP function.
  - B. Analyzed the documentation for the design of the Inventory Delivery System (IDS) and performed queries and/or reviewed samples of surveyed leads and open and/or closed cases to ensure that:
    - 1. all incoming leads were accounted for;
    - 2. only applicable leads were destroyed (e.g., defunct business, Transaction Code 593-Unable to locate accounts, below tolerance accounts) and appropriate notations were recorded on the Inventory Checksheets for the destroyed leads;
    - 3. the audit leads were prioritized by dollar amount and/or statute date;
    - 4. cases were timely assigned, processed into the system, and assessments made after the 60-day holding period;
    - 5. cases were properly referred to other functions when required;
    - 6. the status of the case was properly reflected;
    - 7. accurate management information reports were generated; and
    - 8. assessments were timely and properly posted to taxpayers' master file accounts.

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- C. Reviewed a sample of 30 closed cases with ETAP adjustments to determine whether:
  - 1. tax examiners considered audit issues, filing histories, and wages when ETAP adjustments were made;
  - 2. penalties were properly applied; and
  - 3. payments received in response to ETAP adjustments were input with Transaction Code 640 (Advance Payment of Determined Deficiency) to avoid refunding.
- III. To ensure that management has adequate controls for protecting taxpayer rights, we:
  - A. Determined whether taxpayers were advised of their rights by reviewing cases with ETAP adjustments to ensure that Publication 1 (Your Rights as a Taxpayer), and Publication 5 (Appeal Rights) were mailed to taxpayers.
  - B. Ascertained whether controls effectively ensured that disclosure of taxpayer information by phone or correspondence is only made to taxpayers or attorneys/accountants with power of attorney (POA) status.
  - C. Reviewed employee evaluations to determine whether the use of performance measures or statistics created the potential for abusing taxpayer rights.
  - D. Determined whether adequate procedures were in place at the DCC for referring cases to the Taxpayer Advocate's office when ETAP cases meet Problem Resolution Program (PRP) criteria.
  - E. Requested the Michigan District's Taxpayer Advocate to query the PROMIS database to identify all open and closed PRP cases involving ETAP issues.
  - F. Reviewed the PRP cases identified from the above step to determine whether the taxpayer complaints were timely referred for expedite handling and whether there were any trends to the complaints that indicated systemic or operational problems with the ETAP program.
- IV. To determine whether Service executives in the National Office have provided adequate program direction and developed effective plans for reengineering the ETAP Program to ensure that it is compliant with new legal requirements contained in the Taxpayer Relief Act of 1997, we:

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- A. Obtained from DCC management all documentation of program direction received from the Director, OETAC, and the OETAC Program Analyst who was permanently assigned to the DCC.
  - B. Interviewed the Director, OETAC, to ascertain his role in providing program direction and oversight and his role in directing and/or coordinating changes to the ETAP Program to comply with the new legislation.
  - C. Discussed the ramifications of the Taxpayer Relief Act of 1997 on the ETAP Program with the Assistant Chief Counsel (Employee Benefits and Exempt Organizations).
  - D. Determined the status of any pending Counsel opinions on what the IRS needs to do to make the ETAP Program totally compliant with the new law.
- V. To determine whether Service management is taking sufficient actions to ensure the continuous flow of all available state audit leads to the centralized ETAP Program, we:
- A. Obtained and reviewed copies of the various agreements the IRS has for the exchange of employment tax information with the states.
  - B. Determined the volume of leads being received from each state.
  - C. Interviewed the Director, OETAC; the Director, Federal/State Relations, and DCC management to determine what actions are taken to "market" the ETAP Program with the states, what actions are being taken to establish new agreements with those states which have never provided audit leads to the IRS, and what actions are being taken to "nurture" existing agreements with those states which have stopped providing leads or have provided fewer leads.
  - D. Analyzed the recent survey of district office Fed/State Coordinators to identify which district offices are screening and/or working state audit leads locally instead of forwarding them to the DCC.
- VI. To determine whether remittances received at DCC are physically secured, properly accounted for, and timely posted to taxpayer accounts, we:
- A. Interviewed ETAP managers and employees to secure relevant documentation and an understanding of the internal controls in the remittance processing function.

## **Employment Tax Adjustment Program**

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- B. Prepared a flow chart of the remittance process to determine whether a proper separation of duties exists and whether other appropriate internal controls were established.
- C. Reviewed operating procedures and work practices over remittance processing to determine that sufficient physical and data safeguards are in place.
- D. Traced a representative sample of ETAP remittances from the check log to the bank deposit records and to IDRS to determine whether the payments were promptly processed and properly and timely posted to the taxpayers' master file accounts.



## Employment Tax Adjustment Program

Attachment II



ASSISTANT COMMISSIONER  
(EXAMINATION)

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OCT 29 1998

Seive  
WWW 4000  
9900205  
Chief Inspector

MEMORANDUM FOR CHIEF INSPECTOR

THRU:

*John M. Dalrymple*  
John M. Dalrymple  
Chief Operations Officer

FROM:

Thomas W. Wilson, Jr. *Thomas W. Wilson, Jr.*  
Acting Assistant Commissioner (Examination)

SUBJECT:

Employment Tax Adjustment Program

During June and July 1998, Internal Audit conducted a review of the Employment Tax Adjustment Program (ETAP) at the Detroit Computing Center (DCC) and issued an Audit Report recommending that ETAP be discontinued. This recommendation is based on significant legal and operational issues that exist which seriously undermine the continued existence of the ETAP program at the DCC. These issues include the impact of recent tax legislation, the conflicts with current Examination program guidelines, the risk of creating prior audit safe harbors, and the declining supply of audit leads from the states. This office does not take issue with any of the audit reports findings and concurs in the recommendation to terminate ETAP. We have begun the process of terminating the program in an orderly fashion. We have ceased all production and the Employment Tax Adjustment Program will be totally dismantled by October 1, 1998.

Responsible Official: Acting Assistant Commissioner (Examination)

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OCT 29 1998  
CHIEF INSPECTOR